Sackers

ESG and climate change for pension funds

Putting the law into practice

ESG and climate change for pension funds February 2019

Contents

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Environment

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Introduction

Download our ESG guides from our website.

Welcome to our latest guide for pension trustees on environmental, social and corporate governance (ESG) investment.

In 2016, we launched our first practical guide for trustees on how ESG could be incorporated into pension scheme investment strategies. In May 2018, we published an updated guide following a number of significant developments, including the Government's Environmental Audit Committee (EAC) writing to the largest 25 UK pension schemes on climate change risk.

This, our third guide on ESG, seeks to bring the various strands together after a year in which ESG has been propelled ever higher up pension trustees' agendas.

Following changes to pension scheme investment regulations, from October 2019, pension trustees must update their scheme's SIP to set out their policies on ESG, climate change and stewardship activities. Additional requirements apply from 2020 to trust based DC schemes. Similar changes are anticipated for contract based schemes and their IGCs, following an FCA consultation, expected in the first quarter of 2019.

However, the DWP's investment regulations changes are not the only ones that will impact pension trustees during 2019. New governance regulations that came into force on 13 January 2019 are designed to implement the second European Pensions Directive (IORP II), and have potentially further reaching implications in terms of integration of ESG into trustee risk control processes. Changes are also expected to flow from amendments to the Shareholder Rights Directive (SRD II) (in force from 9 June 2018 and to be incorporated into national law by 10 June 2019). And on top of all that, the EC's Action Plan on Sustainable Finance looks set to bring in new rules on ESG to all financial market participants. On pages 4-6 we summarise the key legal developments and what steps trustees need to take to comply.

Against the backdrop of regulatory change, climate change falls heavily under the spotlight. On pages 7-9 we look at how trustees' fiduciary duties require a prudent assessment of risks and on pages 10-12 we look in detail at how trustees should apply this to their assessment of climate change risks specifically.

In the remaining sections of this guide, we look more closely at stewardship and how ESG and climate change issues should be considered in DC schemes. Finally, on pages 16-17 we set out an action plan for pension schemes, both for those trustees just getting started and for those who want to go further in terms of ESG integration.

We hope you enjoy reading this guide. If you would like to discuss how your scheme can best approach ESG or climate change matters, please speak to any member of the Sackers team.

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UK legal developments

SIPs to be updated by 1 October 2019

Investment Regulations

On 11 September 2018, the DWP published a response to its consultation on changes to the Occupational Pension Schemes (Investment) Regulations 2005, together with a final version of the amended regulations (the Investment Regulations).

Under the Investment Regulations, trustees will have to update or prepare their SIP, **before 1 October 2019**, to set out their policies in relation to:

- “financially material considerations” over the “appropriate time horizon” of the investments including how those considerations are taken into account in the selection, retention and realisation of investments
- the extent (if at all) to which “non-financial matters” are taken into account in the selection, retention and realisation of investments
- undertaking engagement activities in respect of investments (stewardship).

The definition of “financially material considerations” clarifies that these include (but are not limited to) ESG considerations (including, but not limited to, climate change), which the trustees regard as financially material.

“Appropriate time horizon” is defined as the length of time that trustees consider is needed for the funding of future benefits by the investments of their particular scheme. This is intended to allow trustees to consider risks in the context of a scheme’s own profile and maturity. The length of time refers to the scheme (and not the duration of individual investments) and should prompt schemes which are approaching buy-out or wind-up to consider financially material short-term risks, whilst encouraging other schemes to also look towards the longer term in a way which reflects the demographics of their members and beneficiaries.

DC schemes to report annually against their SIP from 1 October 2020

Additional disclosure requirements for DC schemes

From 1 October 2019, in addition to the SIP requirements above, trustees of DC schemes will be required to publish their SIP on a publicly available website and inform scheme members of its availability in their annual benefit statement. Additionally, DC schemes with 100 or more members are required to state a policy in relation to the stewardship of their scheme’s investments in their default investment strategy.

From 1 October 2020, trustees of DC schemes will be required to produce an implementation report setting out how they acted on the principles set out in the SIP. The implementation report must be published online in the same way as the SIP and members informed of its availability in their annual benefit statement. The introduction of the requirement to produce and publish an implementation report is timed to ensure that trustees will not be required to report on the implementation of a SIP which has been produced under the current requirements.

EU derived legislation

IORP II – new European Pensions Directive

In force: January 2017

Aim: to improve governance and accountability in relation to workplace pensions.

Key points for occupational pension schemes:

- Article 19: requires schemes to invest in accordance with the "prudent person" rule
- Article 21: requires schemes to have a proportionate, effective system of governance in place which includes consideration of ESG in investment decisions
- Articles 25 & 28: require schemes to have an effective risk management function in place and carry out an own risk assessment, including considering climate change risks.

SRD II – amended Shareholder Rights Directive

In force: June 2017

Aim: to encourage long-term shareholder engagement and transparency between traded companies and investors.

Key points for occupational pension schemes:

- develop and publish a shareholder engagement policy on the scheme website which describes how investee companies are monitored on matters such as financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, how dialogue is conducted and voting rights exercised
- publicly disclose on the scheme's website how the main elements of its equity investment strategy are consistent with the profile and duration of its liabilities, and how it contributes to the medium to long-term performance of its assets.

In addition, schemes must disclose certain aspects of their arrangements with the asset manager. Asset managers themselves must also make annual disclosures to the scheme.

The Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 (the Governance Regulations)

The Governance Regulations (which came into force on 13 January 2019) are designed to implement aspects of IORP II by updating the current Pensions Act 2004 with a new requirement for the establishment and operation of "an effective system of governance".

TPR is required to set out the details in a new version of its internal controls code of practice including how trustees' systems of governance should consider ESG factors and assess new or emerging risks (including climate change).

A consultation on the new code of practice is expected later this year, with any changes unlikely to take effect before late 2019.

Action: governance systems and arrangements will need to be reviewed against this revised code of practice (once available) and amended as necessary to ensure compliance.

Implementing Regulation (EU) 2018/1212

Came into force on 24 September 2018 and applies from 3 September 2020.

The regulation sets the minimum requirements and standardised formats in relation to shareholder identification, the transmission of information and the facilitation of the exercise of shareholder rights.

UK law

The deadline for implementing SRD II in the UK is 10 June 2019.

As many areas of SRD II are already covered by UK law, it is likely that it will have limited impact on UK companies. However, some legislative changes would be required. This will be an area to watch going forward.

EU legislation on the way

European Commission Action Plan on Sustainable Finance

Timeline

2015: landmark international agreement established with the adoption of the Paris Agreement

December 2016: EC establishes a High-Level Expert Group (HLEG) on Sustainable Finance

January 2018: HLEG delivers final report with its recommendations to enhance sustainable investment

March 2018: EC adopts the action plan on sustainable finance (the Action Plan) in response to HLEG's recommendations

May 2018: EC proposes its draft regulations package of implementing measures (see below)

May – June 2018: EC seeks feedback on amendments to delegated acts under MiFID II and the Insurance Distribution Directive to include ESG considerations

July 2018: EC sets up a technical expert group on sustainable finance to assist in the implementation of the Action Plan

The EC's Action Plan sets out a comprehensive strategy to further connect finance with sustainability, and establishes a range of goals for 2018 and 2019. It is considered key in helping to deliver on the Paris Agreement. Amongst other items, the Action Plan suggests introducing measures to clarify asset managers' and institutional investors' duties regarding sustainability and strengthening transparency of companies on their ESG policies. The EC proposes to define sustainable investments using classification techniques and to regulate disclosures relating to sustainable investments, requiring institutional pension trustees and asset managers to disclose how they integrate ESG issues into their decision making.

Proposed Regulations

On 24 May 2018, the EC published legislative proposals on a package of reforms relating to sustainable finance. The proposals related to three regulations:

- an EU-wide classification system. This regulation establishes conditions and a framework to create a unified classification system ("taxonomy") on what can be considered an environmentally sustainable economic activity
- investors' duties on the inclusion of ESG factors in investment decisions. This regulation will introduce obligations on how institutional investors and asset managers integrate ESG factors in their risk processes and how these must be disclosed to investors. The regulation also proposes further changes to IORP II and embeds ESG considerations within the "prudent person" rule
- new benchmark for low-carbon and positive carbon impact. This will create a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, providing investors with better information on their investment's carbon footprint.

The regulations require the publication of information on how sustainability risks are incorporated into investment decisions.

On 5 July 2018, the UK government published a memorandum setting out HMT's views of the proposals.

The EU Parliament and Council will now consider these proposals. The Action Plan includes a timetable indicating agreement of the legislative proposals in May 2019.

Brexit

The application of EU legislation in the UK after Brexit will differ depending on whether or not a withdrawal agreement is concluded before 29 March 2019. In a no-deal scenario, once the UK has left the EU, it will no longer be obliged to implement EU law into national law. However, provisions in the European Union (Withdrawal) Act 2018 will retain most existing EU law in UK law after exit day.

If there is a transition period, the draft withdrawal agreement provides that most EU law will continue to apply to the UK during this time (until 31 December 2020). Therefore, the UK would have to continue to apply and implement EU law that falls within the agreement's scope during this time.

Fiduciary duties and the prudent person

In our second ESG guide, we explained why pension trustees' fiduciary duty is best articulated as a duty to exercise a scheme's investment powers for "proper purposes". We recap briefly on this below. However, a further element of the fiduciary duty is to exercise those investment powers in accordance with a "prudent person" test. In this section, we look at why this is so important as a key component of responsible investment and the consideration of ESG and climate change issues.

> **"In our view, the fiduciary duty of a trustee is best expressed as a duty to exercise investment powers for their proper purposes, namely investing for the purpose of providing member benefits**

Exercising investment powers for proper purposes

Trustees' investment duties are sometimes defined by commentators as being about "maximising returns". However, this may not always be the best way to look at things, even when considered over the long-term and balanced against the need to control risks.

Trustees do not invest according to a mathematical growth formula, they exercise their investment discretion in the context and circumstances of their scheme at the time. DB pension trustees should have an integrated approach to investment, funding and sponsor covenant, meaning their investment choices, in particular their appetite for risk, will be influenced by the strength of the scheme's funding and employer covenant.

Testing any investment approach against a perceived fixed duty to "maximise returns" will frequently miss the point, as well as being a misinterpretation of the law (see our analysis of Cowan v Scargill overleaf).

The purpose of investment

In a DB scheme, investment powers should be exercised in such a way as to maximise the chances of the defined level of benefits being provided in full. When considering a particular ESG factor or approach, trustees should ask themselves whether they consider it will contribute positively towards that objective. This may well be about whether a particular ESG approach provides an improved "risk-adjusted return". But it may just as equally be about whether taking account of an ESG factor removes or mitigates an insufficiently rewarded risk, or a risk that does not need to be tolerated, in order to provide the promised benefits.

In a DC scheme, the purpose of the investment power is different. In relation to a scheme's default fund, it is to provide a "pot" of money to be used by the member to provide for his or her retirement. And for those members who do not wish to invest in that default fund, the purpose of the trustees' investment power is to provide a range of alternative investment options that are suitable to the needs of the membership. Again, though, the objective will not always be about "maximising returns", other factors may come into play such as avoiding volatility at inopportune moments for the member, improving member engagement, and operating within costs and charges constraints.

1	2	3
DB fund	**DC "default" fund**	**DC "member select" funds**
Invest to provide the specified level of benefits promised under the scheme	Invest to provide a "pot" of money to be used by the member to provide for his or her retirement	Provide a range of investment options suitable for the requirements of the pension fund's members

Cowan v Scargill still applies to trustee fiduciary duties, but context is vital

It is hard to cover trustee fiduciary duties without mentioning Cowan v Scargill, the 1984 case concerning the politically-motivated decision by some of the trustees of the Mineworkers' Pension Scheme (MPS) to avoid investments competing with the British Coal industry. The wording of the judgment that a pension trustees' power to invest "must be exercised so as to yield the best return for beneficiaries, judged in relation to the risk of the investments in question" is still frequently quoted as the basis of a perceived fiduciary duty to "maximise returns".

However, context is everything and the backdrop against which the MPS trustees were exercising their investment power must also be considered. In the MPS, investment returns paid for discretionary increases to pensions which protected members from inflation. The case pre-dated any statutory indexation of pensions. Consequently, the statement that investment powers must be exercised to yield the best returns for the beneficiaries would make complete sense in that context, where the fortunes of the trustees' investment strategy were directly linked to the level of pension that members would receive. However, the wording translates less well to an integrated risk management approach pursued by most modern DB trustees, where trustees are usually investing simply to provide a promised level of benefits.

This is not to say that Cowan v Scargill is bad law, simply that one has to understand the meaning of the judgment in context. In our view, Cowan v Scargill is still good authority for the legal proposition that trustees must exercise their investment powers for their proper purposes (namely, to provide members' pensions and not for politically motivated reasons), but it is wrong to understand the case as binding trustees to an absolute duty of return maximisation.

Exercising investment powers in accordance with a prudent person test

There is a long established principle that trustee investment powers must be exercised with the "care, skill and diligence" a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel "morally bound to provide".[1]

Prudence will always be context specific. What is prudent for a trustee of a fully funded scheme with a negligible employer covenant will be very different to that required for an underfunded scheme with a strong employer covenant. It must also be applied to an investment portfolio as a whole rather than in relation to individual assets – the so-called "modern portfolio theory".

This requirement for fiduciaries to invest in accordance with a prudent person test has been reinforced on a statutory basis the world over and for European pension schemes is legislated for in both IORP Directives.[2]

1 Re Whiteley (1896) 33 Ch D 347 at 355

2 See Art.18 of IORP Directive 2003/41/EU (IORP I), now Art.19 IORP Directive 2016/2341/EU (IORP II)

The trustee fiduciary duty

Exercise investment power for its proper purpose

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Act in accordance with the prudent person principle

Why prudence matters when considering ESG factors

Prudence has always been an evolving concept depending on the economic and financial conditions at the time. Trust investments for reasons of prudence used to be limited to certain government or government-sponsored securities, as well as to stocks of local authorities and certain railways and utilities. It wasn't until the 1960s that legislation was relaxed to permit the sort of equity investments routinely invested in today.

ESG is a fast-growing regulatory concern. On pages 4-6 we set out some of the recent legislative changes with further consultations and regulatory amendments being expected, particularly on the pressing concern of climate change. At the very least, trustees must have a policy on ESG and climate change issues.

Against this regulatory backdrop, it is arguable that we are now at the point where a prudent person dealing with investments for someone else for whom they feel "morally bound to provide" must consider ESG factors and climate change risks. The requirement to do so being borne not out of a duty to maximise returns, but out of a requirement to act prudently.

The prudent and responsible investor

Fortunately, the duty to act prudently is behaviourally oriented rather than outcome focused. That is to say, fiduciaries are judged not by a retrospective assessment of whether their investment decisions were successful, but by whether they followed a reasonable process in reaching their decisions.

Is it a proper exercise of trustees' investment powers?

As trustees consider how (and to what extent) to integrate ESG factors into their investment decision making, some may be inclined to worry how being a responsible investor is compatible with their fiduciary duties. The right question to ask though is not whether the contemplated ESG approach will maximise (or even harm) returns, but whether it is a proper exercise of the trustees' investment powers. In other words, are the trustees doing it to provide a pension rather than for an ulterior purpose. And, crucially, does it form part of an overall investment strategy that a prudent person would adopt as appropriate to the scheme and informed by economic and financial conditions at the time.

On the next three pages, we look specifically at how a duty to act prudently should prompt trustees to consider climate change risk in more detail as they update the wording of their SIP before October 2019.

Climate change: prudence and the inevitable policy response

For UK pension schemes, the DWP has now incorporated ESG considerations in pension scheme regulation. From 1 October 2019, trustees will be required to set out in their SIP how they take account of "financially material considerations", which include ESG considerations with specific reference to the inclusion of climate change. (For further detail please see page 4). It could be argued that climate change is the most urgent of the ESG considerations.

For the last three years, the World Economic Forum has ranked climate change and extreme weather events as the number one global risk.[3] The governments of 184 countries are party to the Paris Agreement, the goal of which is to ensure global average temperature increases remain well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C. Yet, according to the Global Carbon Project, Global CO_2 emissions continue to grow and reached record highs in 2018.[4] As recent US government research concluded:

> **"Earth's climate is now changing faster than at any point in the history of modern civilization, primarily as a result of human activities …[N]either global efforts to mitigate the causes of climate change nor regional efforts to adapt to the impacts currently approach the scales needed to avoid substantial damages to the U.S. economy, environment, and human health and well-being over the coming decades.**[5]

The argument being made, is that if worldwide goals on limiting global warming are to be met, more needs to be done. This could have a significant impact on how pension scheme trustees consider ESG factors.

The consensus

The United Nations Intergovernmental Panel on Climate Change (IPCC) is the internationally accepted authority on climate change. It has produced reports focused on the scientific basis of human induced climate change and its potential impact for the last 20 years. The IPCC recently published a special report noting that human activities are estimated to have caused approximately 1˚C of global warming above pre-industrial levels. Global warming is likely to reach 1.5˚C between 2030 and 2052 at current rates. The impact of global warming at this level will be extreme weather events, drought, rising sea levels and ocean acidity, the destruction of ecosystems, species loss and extinction.

The report's findings highlight that limiting the rise in temperature to 1.5˚C is highly desirable in order to reduce the impact and the cost of mitigation, relative to a 2˚C scenario.

Inevitable policy response

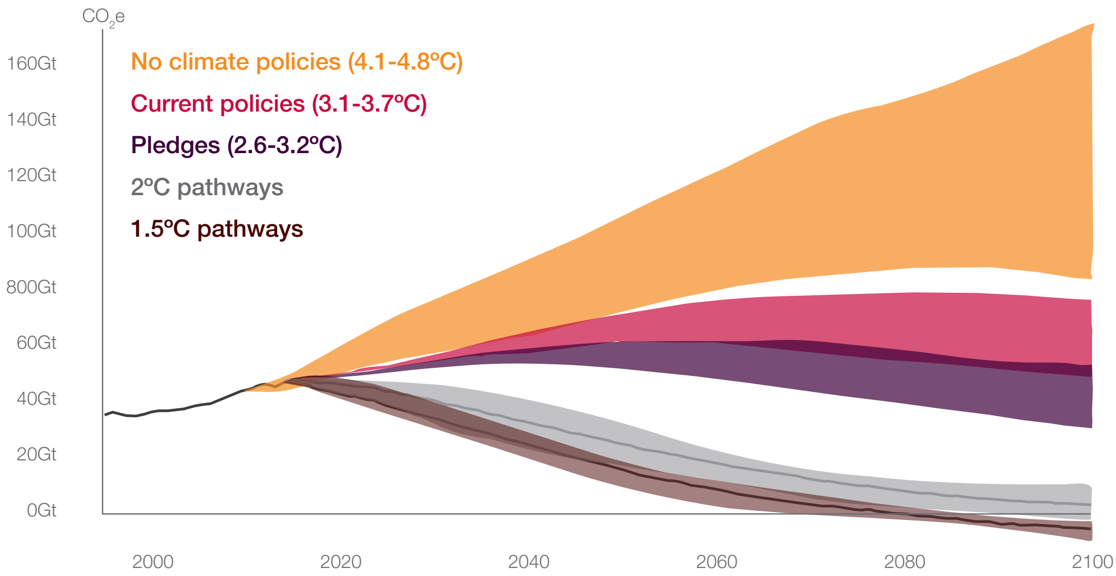
Responding to the IPCC's report, the United Nations Principles of Responsible Investment (UN PRI) argues that on current trajectories global warming poses significant risks to investors as changes on projected scales would have "large and detrimental impacts on global economies, society and investment portfolios". In an alternative scenario, the UN PRI refers to an urgent and forceful "inevitable policy response" if the Paris Agreement goals are to be reached.

3 World Economic Forum, *Global Risk Landscape* 2016, 2017 and 2018

4 Global Carbon Project, *Carbon Budget* 2018, 5 December 2018

5 USGCRP, *Impacts, Risks, and Adaptation in the United States: Fourth National Climate Assessment, Volume II* 2018

Global greenhouse gas emissions scenarios



UN PRI A forceful inevitable policy response will be needed to reduce emissions towards a 2°C trajectory.
Source: Our World in Data

A prudent response

We have examined, on pages 7-9, the importance of prudence as the measure against which trustees' investment decisions should be tested. "Prudence" is tested at the time a decision is made. The current consensus as to the impact of climate change and the political response to this is, therefore, a relevant consideration.

Trustees, reviewing their scheme's investment policy and updating their SIPs, pursuant to the updated Investment Regulations, and considering the impact of IORP II on governance changes, will need to contemplate what actions a prudent trustee would take against this backdrop. For trustees, the challenge will be formulating a meaningful strategic response to the physical and transitional risks (and, of course, opportunities) and ensuring that such response is implemented.

At the time of writing, no UK pension scheme trustees have been sued in relation to their policy on climate change. However, the idea of such a suit is not far-fetched and the potentially long-term financial implications of climate change are likely to increase scrutiny of trustees' response to this issue. ClientEarth recently wrote to the trustees of some of the top UK pension funds warning of the risk of legal action if they fail to develop their approach to climate risk in line with improving data and market practices.

We have previously commented on actions brought in the United States (see our guide "A practical approach to ESG" for further details). More recently, in the ongoing Australian case of Retail Employees Superannuation Pty Ltd v Mark McVeigh (NSD1333/2018), a fund member commenced proceedings against his super fund for failure to sufficiently manage the risks of climate change in his DC investments.

Task Force on Climate-related Financial Disclosures (TCFD)

One initiative which is garnering support is the TCFD, which provides a common approach for companies and institutions, including asset owners, to report on climate change issues within a standardised framework of governance, strategy, risk management and metrics. The framework provides a useful focus and the potential for development of valuable data against which progress can be measured. Compliance with TCFD recommendations may be an appropriate aim for pension scheme trustees and will provide tangible evidence of the trustees' efforts to address climate change risks.

Further reading and content

ClientEarth – an environmental law NGO, its mission is to "use law as a tool to mend the relationship between human societies and the Earth". Their abridged joint opinion The legal duties of pension fund trustees in relation to climate change was published online in April 2017.

EAC – Green Finance inquiry launched in November 2017 to scrutinise the government's strategy to develop "world leading Green Finance capabilities".

Green Finance Initiative – launched in January 2016, the City of London Corporation in partnership with government aims to provide public and market leadership on green finance and to promote London and the UK as a leading global centre for green finance.

IIGCC – the Institutional Investor Group on Climate Change is a forum for investors to collaborate on climate change. The IIGCC website contains many helpful guides for investors. Their guide to addressing climate risks and opportunities in the investment process is a good place to start for trustee investors.

Institute and Faculty of Actuaries Climate Change Working Group – a cross practice working party focusing on climate change.

PLSA Report – "More light, less heat: A framework for pension fund action on climate change".

TCFD – established by the Financial Stability Board, in June 2017 it published its final recommendations, calling for consistent and comparable voluntary disclosures on climate-related risks across sectors and jurisdictions.

UKSIF – UK Sustainable Investment and Finance Association is a membership organisation for those in the finance industry committed to growing sustainable and responsible finance in the UK. Their website includes a checklist which pension trustees can use to consider climate risk management in their decision making.

UN PRI – the UN PRI is the world's leading proponent of responsible investment. The organisation seeks to support an international network of signatories on how to implement and incorporate ESG factors into their investment decision making. Pension funds and investment managers can become formal signatories to its principles. The UN PRI website contains many helpful guides for investors. These include a guide to crafting an investment strategy and an asset owner guide on enhancing manager selection with ESG insight.

Stewardship

From 1 October 2019, scheme SIPs will need to include a statement covering the trustees' policy on engagement activities.

In relation to most DC schemes, the DWP has gone further, requiring the scheme's annual report to include a statement in relation to the default fund. The statement should set out how, and the extent to which, in the opinion of the trustees, the SIP has been met in the previous year. In effect, default funds will have to report back annually on the implementation of their stewardship policies.

For DB schemes, the implementation of IORP II's "own risk assessment" is likely to involve greater reporting in relation to the SIP on a triennial basis, though the details of this are not yet known. However, as we explain below, for the many schemes who have signed up to the FRC UK Stewardship Code (perhaps as a quick and easy fix), proposed revisions to that code in 2019 may require a much more proactive approach from trustees if they wish to remain signatories.

The new FRC UK Stewardship Code

Adoption of the FRC UK Stewardship Code has historically been a convenient approach to stewardship. Regrettably, in some cases, this meant adopting the code without taking any material steps to ensure that it was adhered to.

An overhauled FRC UK Corporate Governance Code 2018, published last summer, has been followed up by a consultation on the FRC UK Stewardship Code in late January 2019. Amongst a broad suite of changes:

- the FRC recognises that significant developments have taken place in the context of sustainable investing since the 2012 code was published
- signatories are expected to take material ESG factors into account. The consultation also suggests expanding the code to encompass non-equity assets such as fixed-income bonds and infrastructure equity, which will be of particular significance to the many schemes which have moved into these asset classes
- the revised code aims to encourage greater demand for an engaged approach to stewardship aligned to investors' time horizons – which for pension schemes will generally be long-term.

Perhaps most significantly, under the revised code, all signatories will be required to make public disclosures about their stewardship activities and an assessment of how effectively they have achieved their objectives. Reporting will be made up of a "Policy and Practice Statement" (required on signing) and an annual "Activities and Outcomes Report". Taking a more passive approach to the code will no longer be an option if these proposals are adopted.

In the longer term, it is also worth being aware that between the publication of the revised FRC UK Governance and Stewardship Codes, the FRC was the subject of what has been described as "withering criticism" in the Independent Review of the FRC (the Kingman Review) in December 2018. The Kingman Review recommends that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers, to be called the Audit, Reporting and Governance Authority. The longer-term future of the FRC's UK Governance and Stewardship Codes is therefore uncertain.

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Further reading

The PLSA Corporate Governance Policy and Voting Guidelines seek to reflect current market best practice and are updated annually. The 2019 Guidelines can be found here.

DC schemes

For DB schemes, the job of the trustees (as covered on page 7) is to invest scheme assets appropriately to pay the scheme's promised benefits. However, in a DC scheme, the objectives are more subtle and may best be thought of as having two key components:

1. To establish a default fund appropriate to the needs of the membership, keeping this under review and updating it as necessary

2. To ensure an appropriate choice of investment arrangements for those members who do not wish to invest in the default arrangement

The pitfall

A common trap to fall into in a DC scheme is to focus on ESG as part of the second component and to largely ignore it as part of the first. A not infrequent refrain from a trustee, in response to an ESG challenge, might be "but we have an ethical fund among the fund choices for people worried about that sort of thing". To look at ESG in this way is to make two fundamental mistakes. First, it confuses the non-financial factor of ethical investment with ESG as a financial factor. The two elements are not the same. Second, it ignores the fact that the vast majority of members are likely to be invested in the default fund and that the trustee duty is to act prudently in those members' best financial interests.

DC Regulation

The DWP has published guidance for trustees on meeting disclosure requirements

On page 4, we set out the new Investment Regulations that will apply to all schemes. In addition, for DC schemes, the regulations require trustees to publish their updated SIP (including details of how ESG and climate change is taken into account in the default fund) on a publicly available website, and to inform scheme members of its availability in their annual benefit statement. DC schemes with 100 or more members are also required to state a policy in relation to the stewardship of their scheme's investments in their default investment strategy.

Further changes will apply from 1 October 2020. Trustees of DC schemes will be required to produce an implementation report setting out how they have acted on the principles set out in the SIP. The implementation report must be published online in the same way as the SIP, and members informed of its availability in their annual benefit statement.

How to approach ESG in the default fund

It is estimated that more than nine million savers have now been auto-enrolled into a workplace pension scheme. At least 90% of those in a scheme "elect" to stay within the default fund.

Members will judge the success of the trustees' investment policy for the default fund by the size of the pension they receive on retirement. However, this will usually be a longer-term assessment. In its DC code of practice, TPR notes that most investments in DC schemes are exposed to longer-term financial risks. "These potentially include risks relating to factors such as climate change, unsustainable business practices, unsound corporate governance etc. These risks could be financially significant, both over the short and longer term."

DC default funds will almost certainly be held in a pooled fund or a combination of pooled funds, and may be accessed through an insurer platform structure. In practice, therefore, ESG is likely to be a case of:

- selecting a fund (or component funds) for the default strategy, the objectives of which take account of the ESG factors which the trustees have identified as financially significant
- monitoring those funds against the trustees' ESG policies.

As with DB benefits, ESG does not stop at portfolio design and manager monitoring. Trustees should also consider how stewardship will be approached in the default fund and whether the stewardship policies, practices and reporting of the selected pooled fund managers are appropriate. Trustees may wish to consider engagement overlay strategies where feasible within costs and charges constraints.

Members' views

One of the more controversial elements of the DWP's consultation on the new Investment Regulations was an original proposal that trustees should be required to publish a "member views statement" setting out the extent to which they took account of members' views on "non-financial factors", including ethical considerations. The proposal saw opposition from most respondents to the consultation, with the result that the finalised regulations contained only an "option" for trustees to include a policy on the extent to which non-financial factors are taken into account, if at all.

For trustees responsible for DC schemes, the primary focus should be on constructing a DC default fund that the trustees judge to be in the best financial interests of the members invested in it (and in many cases auto-enrolled). This should include a consideration of ESG and climate change issues as financial factors. Member views might be an additional pertinent factor for some schemes such as those attached to a charity or religious organisation, but we would caution against most trustees starting from member views when thinking about ESG in their DC default fund. However, this is not to say that member views do not have any place in trustees' investment decisions. Trustees may wish to get a better understanding of what DC members want in order to ensure that they provide an appropriate range of alternative funds (potentially including ethically based ones or ones pursuing specific social impact objectives) for members who wish to invest in this way.

Forthcoming FCA consultation on contract-based DC and IGCs

So far, the regulatory changes on ESG and pensions only apply to trust based schemes. However, in October 2018, the FCA published its own Discussion Paper on climate change and green finance, citing that "climate change is likely to have a significant impact on the UK's economy and financial services markets". As well as considering whether to require asset managers and other financial services firms to report publicly on how they manage climate risks, the discussion paper promises a consultation on rules and guidance for providers of contract-based DC schemes, setting out how those providers should consider ESG and climate change risks as financial factors. The consultation is also likely to cover how IGCs report their firms' policies on evaluating ESG, climate change and stewardship.

Further reading

PLSA: ESG risk in default funds: analysis of the UK's DC pension market

DCIF: Navigating ESG – A practical guide

Government Advisory Group: Growing a Culture of Social Impact Investing in the UK

A plan for ESG and climate-change integration – from behind the curve to getting ahead

Action plan	Behind the curve Unlikely to stand up to any serious scrutiny	Getting compliant Putting ESG on the agenda
Your Action Plan		
1 Set investment beliefs	Trustee board relies on its investment consultants to tell them what to believe. Sets nothing out in writing.	Trustee board receives a brief training session before minuting that ESG and climate change are considered material financial factors.
2 Review existing managers	No engagement with existing managers.	Takes stock of existing managers and uses investment consultant scoring framework to rate current managers on their ESG credentials. However, scores are only used as a differentiator where there are other reasons to review a manager.
3 Set a DB investment strategy	Existing strategy not reviewed.	Trustees keep existing strategy under review as ESG experience develops.
4 Consider DC benefits	Does not consider ESG in default fund. Falls into the DC "trap" considering the provision of an "ethical fund" as a self-select option to be sufficient (see page 14).	Reviews default fund. Manager expected to demonstrate ESG credentials. For passive funds, this may be limited to more active stewardship.
5 Document a policy	Adds generic wording to SIP at suggestion of the investment consultant in the belief that this will make the trustee "compliant". Trustees do not consider wording or how it will be implemented in practice.	Trustees consider wording in the SIP reflecting the circumstances of the scheme and existing manager mandates. Trustees agree how wording is implemented in practice with their investment consultants.
Further considerations		
Monitor manager	Reports on quarterly past performance figures only. No forward looking consideration of manager ESG attributes or exposure of mandates to climate change risk in the longer term.	Expects active managers to demonstrate how ESG criteria are being used in stock selection and de-selection.
Appointing new managers	Mentions ESG only as an afterthought in tender invitations and gives it no weight in selection criteria.	ESG is identified in tenders as an important issue on which potential new managers will be expected to demonstrate competency.
Stewardship and engagement	Not considered relevant. Justified based on an incorrect assumption that the scheme's investments are all pooled and therefore "stewardship is impossible".	Trustees expect managers to report on how they have exercised voting rights attached to shares (including across passive equity mandates). Managers are expected to be signatories to the FRC UK Stewardship Code.
Scenario testing	None.	Obtains broad estimates from consultants as to the potential significance of climate change on the scheme's portfolio.
Reporting	Sends stock wording to any members "causing a nuisance".	Some commentary provided to scheme members in annual report.
Industry involvement	None.	Relies on advisers to provide updates on significant developments, requiring action and training as required.

On the front foot Embedding ESG into trustee governance	Getting ahead Making ESG and climate change a key strategic issue
Trustee board spends time on training before discussing and agreeing a responsible investment beliefs statement, including a position on climate change risk.	Trustee board discusses ESG beliefs at least annually. Where applicable, trustees seek to align beliefs with sponsor views. Considers alignment of strategy with UN Sustainable Development Goals.
Full consideration of each manager's ESG capabilities (including qualifications) with specialist input from investment consultants – includes being alive to "green-washing". Managers which require most attention identified and engaged with. Where no improvement is forthcoming, or possible within current mandates, these will be reviewed.	Expects all managers to demonstrate deep ESG integration. Integrates corporate environmental data in manager investment processes.
For active mandates: considers diversification across sources of climate risk as well as traditional asset classes. Sustainability and low carbon indices considered for passive allocations.	Positive allocation to sustainable investment or investment in assets aligned with a below 2˚C pathway. Consider tilting portfolio away from lower scoring ESG assets or sectors such as high carbon emitters.
Reviews composition of DC default to manage ESG risks and align with trustees' ESG beliefs. Regularly reports to members on how default fund is responding to climate change.	Uses ESG leaders or factor-based funds as default. Self-select fund choices include "impact" investment funds with ESG goals. Considers seeking member views to ensure an appropriate fund range.
Trustees develop a stand-alone responsible investment policy which supplements the SIP. This may start with existing manager mandates but will progress to deeper integration of ESG factors over time. The policy is periodically reviewed.	Extensive responsible investment policy with detailed consideration of ESG in each asset class, detailed climate change policy and stewardship policies. Climate change risk embedded across other trustee governance and internal control frameworks and considered as part of an integrated risk management framework (including any climate change risks pertinent to the scheme sponsor covenant).
Develops a robust monitoring process – reporting qualitatively and quantitively against each manager. Managers expected to demonstrate integration of ESG in investment processes rather than the existence of separate "advisory" ESG analysts.	Managers expected to provide frequent concrete examples of deep ESG integration. Measures alignment of listed equity and corporate bond portfolios across 2˚ transition sectors and technologies.
ESG credentials key in tender process. Investment management agreements negotiated to include specific ESG requirements.	Responsible investment requirements included across all asset classes including eg side letter terms in private equity funds.
Expects managers to report in detail on their engagement policies and how these have been implemented. This should include examples of voting against the board on ESG related issues. Managers with a poor engagement record will be downgraded. Considers adoption of an off-the-shelf voting policy eg AMNT Red Lines.	Large schemes: takes an active and direct role engaging with investee companies across all asset classes. Considers joining other investors in filing climate-related shareholder resolutions where companies are underperforming on adaptation or disclosure. Small schemes: appoints proxy voting and engagement service reflecting trustees' ESG beliefs and position on climate risk.
Considers carbon foot-printing tests on portfolio. This may focus initially on listed equities and corporate bonds.	All-portfolio risk assessment (including all real asset holdings) to identify exposure to transition risks and potential physical damage risk under different climate scenarios.
Considers TCFD reporting framework as a structure for internal governance.	Reports publicly against TCFD.
Trustees keep abreast of industry discussions and attend events to improve knowledge and observe best practice. Considers becoming a UN PRI Signatory.	Joins investor groups such as IIGCC. Engages with policy makers to improve practice across the industry.

How we can help

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over sixty lawyers focus on pensions and its related areas, including Sackers' finance and investment group, a team of lawyers who provide cutting edge advice to trustees, employers and providers on all aspects of pension scheme finance and investment.

We advise on the development and implementation of ESG strategies consistent with trustee fiduciary duties and the development of trustee ESG and engagement policies, including how to document trustee responsible investment policies and related wording for a scheme's SIP. We also provide ESG training for trustees and pension scheme providers.

For further information and advice on ESG and climate change considerations for UK pension schemes, contact any of the contributors to this guide using the details below, or your usual Sackers' contact.

Stuart O'Brien, Partner
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Key areas of expertise include: buy-ins and buy-outs, LDI, investment management agreements, ESG issues including fiduciary duties, policy, stewardship, responsible and impact investing.

Ralph McClelland, Partner
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Key areas of expertise include: fiduciary management, custody arrangements, the Local Government Pension Scheme, all types of pooled investment products, and ESG including stewardship and climate change issues.

Jacqui Reid, Partner
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Key areas of expertise include: DC investment strategy, regulation and industry best practice for IGCs and providers, member engagement and value for money.

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Key areas of expertise include: investment management agreements, pooled and segregated mandates, custody arrangements, and ESG issues.

Abbreviations

AMNT: Association of Member Nominated Trustees

DB: Defined benefit

DC: Defined contribution

DCIF: Defined Contribution Investment Forum

DWP: Department for Work and Pensions

EAC: Environmental Audit Committee

EC: European Commission

ESG: Environmental, social and corporate governance

EU: European Union

FCA: Financial Conduct Authority

FRC: Financial Reporting Council

HLEG: High-Level Expert Group

HMT: Her Majesty's Treasury

IGC: Independent governance committee

IIGCC: Institutional Investors Group on Climate Change

IORP: Institutions for Occupational Retirement Provision

IORP II: Institutions for Occupational Retirement Provision Directive (EU) 2016/2341/EC

IPCC: UN Intergovernmental Panel on Climate Change

LDI: Liability-driven investment

MiFID II: Markets in Financial Instruments Directive 2014/65/EU

NGO: Non-governmental organisation

PLSA: Pensions and Lifetime Savings Association

SIP: Statement of investment principles

SRD II: Shareholder Rights Directive (EU) 2017/828

TCFD: Task Force on Climate-related Financial Disclosures

TPR: The Pensions Regulator

UKSIF: United Kingdom Sustainable Investment and Finance Association

UN: United Nations

UN PRI: United Nations Principles of Responsible Investment

USGCRP: United States Global Change Research Program

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